

Written Testimony of
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Before
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Advisory Committee on the Auditing Profession
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Dear Chairmen Levitt and Nicolaisen and Committee members:

Thank you for this opportunity to share my ideas and experience as well as those of my firm concerning competition and concentration in the market for public company audits and about other topics related to the committee's mission.

JH Cohn currently has approximately 1,200 partners and employees working in ten offices in the U.S., mostly in The New York Metropolitan Area. Our revenues were \$221 Million during our most recent fiscal year that ended January 31 of this year. We have grown in excess of 100% over the past five years. Public Accounting Report ranks us the seventeenth largest CPA firm in the U.S. We currently audit sixty-three SEC registrants. Our public company audit practice represents approximately five percent of our total revenues. The focus of our audit practice is centered on middle market companies with revenues up to \$1 Billion. The majority of our audit clients have revenues below \$500 Million.

I am our firm's Capital Markets and SEC Practice Director and an auditor of both public and private companies. My auditing experience dates back to the early 1970's and I have been auditing public companies since the early 1980's.

JH Cohn is in the process of expanding its presence in the public company audit market. We have determined that a firm of our size is better able to serve the middle market with a presence in the public company audit arena. As our clients grow and wish to access the capital markets, we desire to continue to serve them and have built up sufficient resources and technical quality in order to do so. In addition, as we expand our practice we are moving "up market" and attempting to attract companies that are already public.

JH Cohn brings a number of strengths to the table that makes us not only a viable option as an auditor for some public companies but, in an increasing number of cases, a preferred option. While not all firms of our size and background are interested in expanding in the public company audit market, there are a sizable number of CPA firms that have either already decided to increase their presence in the public company audit market or are seriously considering such a move. Although the hurdles may differ slightly from firm to firm, most of us desiring a greater presence in the public company audit market face similar issues in implementing our strategies. Some of these hurdles arise from internal constraints that we need to address and change, but others arise from conditions and circumstances that are beyond our immediate ability to effectively change ourselves. The recommendations of The Committee

could have significant positive effects on those conditions beyond the scope that smaller CPA firms could affect. I will try to highlight those areas in the following remarks.

The committee has already heard from Wayne Kolins of BDO Seidman and Neal Spencer of BKD. Some of my remarks today will echo what they have said. Others may differ or provide a slightly different perspective. My views on these concerns reflect only my experiences and my perceptions of the experiences of others. Hopefully, they will provide committee members with a more complete appreciation of the current state of the auditing profession from the perspective of a mid-tier firm and provide some basis for forming your final recommendations.

Competition and Concentration in the Market for Public Company Audits

The recent draft report from this Committee, as well as several previous commentators, cited the GAO Report on Competition in the Audit Industry, and identified the extent of the concentration of public company audits in the four largest audit firms, which in 2006 audited 98% of the 1,500 largest public companies with annual revenues over \$1 billion and 92% of public companies with annual revenues between \$500 million and \$1 billion. On the other hand, the draft report also recognized the significant growth in the number of smaller public companies audited by regional and local audit firms, citing the decrease from 44% in 2002 to 22% in 2006 in the largest firms' share of the market of public companies with annual revenues under \$100 million and the decrease from 90% in 2002 to 71% in 2006 in their share of the public companies with revenues between \$100 million and \$500 million. Accordingly competition and choice have improved in recent years in the market segment of public companies under \$1 billion in revenues. Whether this trend continues, and whether the trend can be extended to public companies over \$1 billion in revenues, remains an open question. More recent reports on trends in auditor switching document that the largest firms have experienced slight gains in market share at the small end of the size scale over 2007 and the first part of 2008 with the other segments remaining about the same.

The segment of the market where JH Cohn competes is at the smaller end of the size scale, one where the number of potential audit firm competitors is substantially larger than in the segment comprising the largest, global public companies, where an auditee may be effectively choosing from a potential universe of six or even fewer global networks. Although regional and local firms would most likely have the capacity and the desire to audit some of the public companies that would come into the market if another larger audit firm failed, the largest clients of such a failed firm would face very limited choices. An audit firm of our size is unlikely to take on an audit client whose size or other characteristics pose problems or risks that potentially overwhelm the firm's resources and capacities. Smaller firms are able to secure liability insurance because they both maintain a client list well within acceptable risk limits for their capabilities and take great care in the performance of audits.

Internal Challenges to Expand Public Company Audits

Some of the hurdles faced by smaller CPA firms that desire to expand the number of their public company audit clients consist of the difficulty in establishing the internal infrastructure for handling either large numbers of public company clients or very large public company clients. Most of these internal hurdles arise because smaller firms, due to their size,

cannot leverage economies of scale in certain areas. In some cases, while we may have the knowledge and expertise to audit a smaller public company in a given industry, we may not have enough staff people to audit a large public company in the same industry. Also, smaller CPA firms generally have many more private companies as clients than public companies. A CPA firm can provide more services for a private company audit client than for a public company audit client. The service model and culture in smaller CPA firms is built around the biggest piece of the practice, which is almost invariably the private company side. Establishing a critical mass of public company audit clients to support the internal compliance infrastructure for SEC independence tracking, SEC accounting and disclosure requirements in addition to GAAP, PCAOB inspections, and the administrative structures to develop new engagement and concurring partners to satisfy the rotation rules requires quite a bit of time and money.

The following comprises those areas that smaller firms must develop in order to expand their presence in the market for public company audits. Most of what I discuss below requires a substantial investment in overhead infrastructure that usually does not result directly in a revenue stream. Because complete development of infrastructure is often costly and accomplished incrementally, economic barriers can postpone the complete development until a revenue stream is in place. Firms like JH Cohn continuously work on these items to improve our presence in the public company audit market, where we can shape our own destiny to a great extent.

- Professional standards expertise in accounting principles, rules, and regulations wherever a public company client may be subject to regulated financial reporting requirements.
- Industry expertise in all industries that might affect a public company client.
- Participation in national and international affiliations of firms with robust enough standardization to be able to rely on the work the affiliations' in the public company audit arena.
- Development of quality control systems and people commensurate with the responsibilities and risk associated with public company audits.
- Interactions with federal regulators and standards-setters are infrequent and can lag substantially new developments. Smaller firms do not have people, especially at the partner level, dedicated solely to dealing with SEC or PCAOB issues.
- Business development and firm brand-name building through participation on prestigious panels, commissions, and other high-profile professional and business activities where high level policy setters and decisions makers gather is also often difficult for smaller firms to fund from both an economic and human capital perspective.

External Challenges to Expand Public Company Audits

External challenges are ones that arise from the environment in which we operate. They frequently concern matters that elude the efforts of mid-tier firms to affect by themselves. These types of challenges could be mitigated resulting from the recommendations of this Committee.

- Many decision-makers and decision-influencers, in the choice of an auditor, either worked at one point in their career for one of the largest audit firms, or have had significant experience with the largest audit firms during their careers. It is understandable under such circumstances that there would be a bias toward familiar

names and large size. On the other hand, if there is a genuine public policy need to expand the number of public company auditors, then in cases where the bias is inaccurate, authoritative information needs to be available to provide a more balanced view.

Two of the recommendations of the Committee address this problem in a way that will likely help the situation. First, the recommendation for more complete information related to auditor switches would better inform market participants of pertinent information related to this important change. The Committee may wish to consider recommending additional disclosure from the company and the successor auditor about any conditions created by others that may have influenced their relationship. Second, we would support the recommendation that the PCAOB determine the feasibility of developing key indicators of audit quality and would welcome the opportunity to work with them and other market participants to study this area. We recognize the inherent difficulty in identifying key indicators of audit quality and that a great deal of work and understanding of the operating model of an audit firm will be required to determine the feasibility of such measures.

- More opportunities such as this testimony for leaders of smaller firms to participate in important public policy discussions about the public company audit profession would over time enhance public understanding and acceptance that high quality in auditing is achievable in different forms and packages. Likewise, more opportunities for participation in roundtables and other discussions at the SEC, PCAOB, and at conferences and other gatherings would be helpful in establishing awareness in the public eye of mid-tier firms. Even though the Center for Audit Quality has helped raise the awareness and supports the involvement of smaller firms, there is still room for improvement.

Committee Recommendations that Could Lessen Smaller Firm Expansion in the Market for Public Company Audits

Some of the recommendations put forward by the committee may provide disincentives for many smaller firms to actively pursue expanding into the public company audit market. Allow me to identify those recommendations and provide the reasons they could have a negative effect.

- While many smaller firms organize advisory groups for a variety of purposes to help them provide better service, understand their markets more completely, and help them increase their reputation and market presence, few smaller CPA firms would be able or willing to easily handle public voting members on their boards. Some impediments that would need to be addressed include various state regulations, fiduciary responsibility, and personal liability. More importantly, it is unlikely that individuals without ownership positions and audit experience would responsibly assess all the risks associated with operating a CPA firm. There would need to be clarity that the fiduciary duty of the independent board member is to the public accounting firm and board on which he or she serves. Lastly, many public company audit firms are unable to obtain management liability insurance for their own personnel. Accordingly, the ability to contract for appropriate levels of D&O and other insurance for independent board members will need

to be explored. The Committee should also remember that in smaller firms the public practice is a small percentage of overall revenue. It is possible that non-SEC partners would have difficulty in accepting the concept of public voting members on their boards.

- Public disclosure of firm financial statements would also pose perhaps insurmountable difficulties for many smaller CPA firms, causing them to withdraw from the public company audit market. They would view such disclosure as placing them in a negative competitive position with respect to larger audit firms, current and potential clients, and potential plaintiffs. Exempting smaller firms from such public disclosures while requiring them of large firms would probably lead to more concentration rather than less since the non-disclosing firms that are competing with the disclosing firms will be pressured by potential clients to disclose their financial information or risk losing the bid. Public disclosure of other aspects of audit firm activities, such as governance, ownership, affiliations and networks, quality control provisions, promotion and evaluation policies, insurance provisions, and key indicators of audit quality would probably be more readily accepted among small firms. The role of PCAOB oversight of audit firms and consistency with what may be required in other countries should also be considered before requiring public disclosures.
- Annual shareholder ratification of public company auditors, while somewhat commonplace today, may continue to restrict competition if adopted as a requirement. We believe that audit committees working with a company's key officers are in a better position to recommend the proper public accounting firm than its shareholders. The shareholders may wish to have a firm with a "name" without understanding the qualifications of a lesser known firm. In addition, would such shareholder ratification preclude a company from changing auditors within a year once ratification were to have occurred?

Committee Recommendations that Could Help Smaller Firms Expand their Presence in the Market for Public Company Audits

- The recommendations for creating a national center for auditors and other market participants to share experiences and develop best practices for fraud detection would be very helpful in assisting smaller firm auditors to address fraud detection and prevention more completely. We would support the creation of this type of center within the Center for Audit Quality. We also believe that amendment of the auditor's opinion to better communicate the responsibilities of boards, managers, and auditors in preventing and detecting fraud under the current standards would be helpful. In addition, the development of case studies based upon known frauds would not only enhance auditor learning but that of college students as well. One of the most difficult concepts to teach young accountants is that of professional skepticism. Efforts at helping them understand that fraud does, in fact, occur and doing so at an early stage in their careers will greatly improve audit quality.
- The threat of a massive audit failure is an effective deterrent to taking on audit clients beyond a firm's scope in most cases. The more threatening the liability environment the less likely smaller firms are to take on larger public company clients. For many smaller firms, one significant audit failure is enough to damage its reputation so

completely that its existence would be threatened without regard to a mechanism for preservation and rehabilitation. It can also be the case for a smaller firm that association with a failed client may pose significant litigation risks and high costs of defense even when the audit firm has performed its responsibilities at a high level of quality. For smaller firms, insurance availability is extremely important.

- As Secretary Paulson said in his November 20, 2006 speech, "But our legal system has gone beyond protection." As an example, my firm recently had the opportunity to pursue a sizable public company that was within our capabilities to audit. In discussions with one of their officers, who had been in public accounting, the officer mentioned that due to a significant amount of company debt due within one year, he couldn't understand why a new firm would be interested in representing the company. Why would a firm want to be associated with a company that might not survive and then be involved with the potential lawsuits that could ensue? Clearly, the accounting firm would have had nothing to do with the company's failure yet our tort system would drag the new firm into various court actions.
- The recommendation to require public disclosure of agreement provisions limiting auditor choice is an excellent one. We might add to this our opinion that agreements to limit auditors are in essence related to the aforementioned liability issue as underwriters and banks fall prey to the same "broken tort system" as Secretary Paulson stated in his 2006 speech.
- We are in agreement with The Committee's recommendation to compile certain independence rules into a single document and would encourage the expansion of that compilation beyond just the SEC and PCAOB rules to include those of the DOL and others. In addition, it would be helpful to encourage the various state boards to adopt a uniform standard on independence possibly through a provision within the Uniform Accountancy Act. We believe auditors are keenly aware of our requirement to remain independent and we embrace the concept. However, with the morass of rules in existence inadvertent violations may sometimes ensue. In addition to the compilation of our independence standards, The Committee needs to consider the effect of the international standards and possibly include them as well. We would envision a codification of the rules similar to what the FASB has undertaken with its codification of GAAP.
- The partner rotation rules are an important element in effectively protecting our capital markets structure and can be effective in bringing fresh thinking to engagements. We believe that for smaller accounting firms these requirements might be enhanced by allowing concurring partners and additional year or two over the current limitation of five years. Often both the engagement partner and the concurring partner are forced to rotate off an engagement at the same time thereby depriving the client of the knowledge gained about their business during the previous five years. By allowing a concurring partner an extra year or two, that partner could take over from the engagement partner which would allow a more efficient transition period.

Closing

The most appropriate auditors for a public company may depend more on where the company falls along a number of dimensions -- size, geographical dispersion, industry, complexity of operations or transactions, and management and governance characteristics -- and the ability of an auditor to match up to those company characteristics with adequate capacity than on the size of the auditor alone. Our clients understand the value we bring through our knowledge of accounting and their businesses as well as through the service model we have developed to satisfy their needs and demands. Among the most important outcomes from the work of this Committee will be greater public awareness and appreciation of the breadth and depth of all the audit firms engaged in public company audits.

Once again, thank you to the Chairmen and to the Committee for the invitation to make this submission and sincerely appreciate our involvement.